

## Construction and Land Development

Consider the following procedures at each examination. Examiners are encouraged to exclude items deemed unnecessary. This procedural analysis does not represent every possible action to be taken during an examination. The references are not intended to be all-inclusive and additional guidance may exist. Many of these procedures will address more than one of the Standards and Associated Risks. For the examination process to be successful, examiners must maintain open communication with bank management and discuss relevant concerns as they arise.

### POLICY CONSIDERATIONS

1 Determine whether policies and procedures promote prudent lending practices. Consider the following items within the context of the bank's size and complexity:

- 1 A Feasibility studies, risk analyses, and sensitivity of income projections to economic variables.
- 1 B Minimum requirement for initial investment and equity maintained by the borrower.
- 1 C Standards for net worth, cash flow, and debt service coverage of the borrower or underlying property.
- 1 D Standards for the use of interest reserves or stipulation that interest reserves will not be used.
- 1 E Standards for the level of speculative loans relative to capital.
- 1 F Pre-sale and minimum unit release requirements for non-income producing property loans.
- 1 G Limits on lending with partial or no recourse to borrowers, if permitted.
- 1 H Take-out commitment requirements.
- 1 I Minimum covenants for loan agreements, such as financial statement requirements.
- 1 J Periodic inspections during the construction phase.
- 1 K Lien waivers from subcontractors.
- 1 L Disbursement controls.
- 1 M Inventory control records of unreleased units.
- 1 N Curtailments when original projections are not met.
- 1 O Certificates of occupancy.
- 1 P Joint ventures, such as profit sharing or equity arrangements.
- 1 Q Equity withdrawals from loan proceeds.
- 1 R Contractor's performance bonds for loans over a specified dollar amount.
- 1 S A survey before construction and after the foundation is in place to insure proper setbacks are maintained.

- 1 T Procedures to insure that the project complies with local codes and meets certificate of occupancy requirements. (Wetlands determination, zoning appraisals, and percolation results.)
- 1 U Maximum loan amount, pricing, and maturity by type of property.
- 1 V Value and marketability of the mortgaged property.
- 1 W Secondary sources of repayment.
- 1 X Additional collateral or credit enhancements.

## ADMINISTRATION

2 Determine if management monitors real estate markets and local economic conditions within the bank's trade area. Consider the following items:

- 2 A Demographic indicators, including population and employment trends.
- 2 B Zoning requirements.
- 2 C Current and projected vacancy, construction, and absorption rates.
- 2 D Current and projected lease terms, rental rates, and sales prices, including concessions.
- 2 E Current and projected operating expenses for different types of projects.
- 2 F Trends in loan applications and originations.
- 2 G Valuation trends, including discount and direct capitalization rates.
- 2 H Political considerations:
  - 2 H1 1. Zoning and mapping approval process within subject area compared to surrounding counties or political units.
  - 2. Fees and other taxes as compared to other political units.
  - 3. Wetland, environmental, density, water sharing, and miscellaneous issues.

3 Determine if the bank is providing permanent financing. (Note: If the bank provides permanent financing, determine if credit terms are consistent with the bank's normal underwriting standards.)

4 Review loan histories as needed for the following items:

- 4 A Disbursements conforming to loan agreements. For example, funds earmarked for hard costs should not be used for soft costs such as interest, marketing, administrative, architectural, engineering, or legal expenses.
- 4 B Lot releases corresponding to principal payments.

## DOCUMENTATION

5 Determine if the following loan documents are on file:

- 5 A Mortgage (or deed of trust).

- 5 B Note.
- 5 C Attorney's opinion or title insurance.
- 5 D Appraisal or collateral evaluation.
- 5 E Evidence of appropriate insurance (property, liability, flood).
- 5 F Feasibility study.
- 5 G Business plan for the development.
- 5 H Take-out commitment(s).
- 5 I Commitment letter (the final signed version).

## **CREDIT ANALYSIS**

6 Determine if acquisition, development, and construction credit decisions and loan administration include the following credit evaluation factors:

6 A Feasibility study that includes, if applicable to the project, the following items:

- 6 A1 1. Economic and environmental issues.
- 2. Engineering surveys and tests.
- 3. Soil borings.
- 4. Character of adjacent properties.
- 5. Flood plain and water table concerns.
- 6. Intrusions.
- 7. Seepage.
- 8. Zoning.
- 9. Political impact.
- 10. Jurisdiction of state and Federal agencies.
- 11. Water availability.

6 B Reasonable steps to determine borrower, developer, and contractor qualifications and reputation. Items to consider include the following:

- 6 B1 1. Construction experience of the borrower, developer, and contractor.
- 2. Payment history from suppliers, trade creditors, and major subcontractors.
- 3. Credit reports.

6 C Take-out commitments.

6 D Financial capacity of the take-out lender.

6 E Marketability of properties without take-out commitments.

6 F Borrower's outside repayment sources.

6 G Control of funds when the loan agreement contains hold back, retention, or interest reserve provisions.

- 6 H Adequate hazard, builder's risk, and workman's compensation insurance with the bank named as loss payee where appropriate. (Note: The bank may have provided for additional coverage in the event the borrower's insurance lapses.)
- 6 I Lien searches prior to disbursement of loan funds.
- 6 J Lien priority as additional funds are advanced.
- 6 K Timely payment of subcontractors and suppliers.
- 7 Determine if the undisbursed loan balance is sufficient to complete the project. Consider the following items:
  - 7 A Reports used to monitor construction progress, advances, sales, and pertinent factors.
  - 7 B Inspection reports:
    - 1. Compare budget to actual costs.
    - 2. Compare draws to degree of completion.
- 8 Determine if the construction loan amount and the project's estimated completion date correspond to the amounts and expiration dates of the take-out commitment and completion bonds, if any.
- 9 Determine if loans are based on inflated collateral values caused by rapid turnover of ownership but without any corresponding property improvements (for example, land flips). (Note: Uniform Standards of Professional Appraisal Practice (USPAP) require a discussion of the property's recent sales history.)